

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFPH:ATL:POSTF-109498-02 WLI-2
KAPalmerino

date: August 26, 2002

to: Danny Horner, International Examiner
Rita Cox, Team Coordinator
D. Redigo Phillips, Team Member

from: Associate Area Counsel (LMSB)

subject: Basis of Stock in [REDACTED] at the date of
disposition of that stock.

This is in reply to your request dated May 14, 2002 and subsequent discussions and correspondence concerning [REDACTED] basis in the stock of [REDACTED] at the time of the disposition of that stock. This memorandum should not be cited as precedent.

Conclusion:

[REDACTED]'s basis in the stock of [REDACTED] should be reduced to reflect its additional basis in the stock of [REDACTED] as a result of the deemed section 351 transfer of a portion of [REDACTED]'s stock ownership in [REDACTED] to [REDACTED].

Facts:

[REDACTED] is the U.S. parent which owns [REDACTED] percent of the stock of [REDACTED], a [REDACTED] corporation. In [REDACTED] owned all of the issued and outstanding common stock of [REDACTED], a [REDACTED] corporation and had a U.S. dollar basis in those shares equal to \$[REDACTED].

In [REDACTED], in exchange for cash, [REDACTED] issued [REDACTED] notes to [REDACTED] in the total face amount of [REDACTED] which were valued at \$[REDACTED] when translated at the rate of \$[REDACTED] = [REDACTED]. The notes were identical, for terms of [REDACTED] years

and were subordinated, non recourse, and non interest bearing. The notes were treated as debt for [REDACTED] purposes and were treated as equity for U.S. purposes. Stock had not been issued to [REDACTED] to reflect its investment in [REDACTED].

The notes from [REDACTED] to [REDACTED] provided that the holder had the right to convert the notes to stock at any time upon notice being provided to [REDACTED]. The number of shares of stock to be issued by [REDACTED] upon such conversion was to be agreed upon at the time of the conversion but the stock that was issued upon conversion was agreed to be equal to the face amounts of the notes.¹

Based on the value of their respective equity contributions, the percentage interests of [REDACTED] and [REDACTED] in [REDACTED] were [REDACTED] percent and [REDACTED] percent, respectively.

The LMSB Examination team does not challenge [REDACTED]'s treatment of the notes as stock for U.S. purposes.

[REDACTED] made a decision to financially reorganize [REDACTED]. In order to accomplish its goal to convert [REDACTED] into a [REDACTED] and then to make a check-the-box election, [REDACTED] was required by [REDACTED] law to cure the "negative equity" in [REDACTED]. Accordingly, on or about [REDACTED], [REDACTED] and [REDACTED] converted part of the [REDACTED] notes to equity in an amount equal to [REDACTED] (\$ [REDACTED] translated at the rate of \$ [REDACTED] = [REDACTED]). At the same time [REDACTED] forgave [REDACTED] of the notes (\$ [REDACTED]). After this restructuring [REDACTED] had a remaining payable on the note to [REDACTED] of [REDACTED] ([REDACTED] - [REDACTED] + [REDACTED] [REDACTED]).² The books of both companies reflected this change.

According to [REDACTED], after this transaction [REDACTED] owned [REDACTED] percent of [REDACTED] and [REDACTED] owned the remaining [REDACTED] percent, or roughly the same percentages prior to the conversion and the debt forgiveness. [REDACTED] asserts that its basis in the shares obtained as a result of the conversion of the [REDACTED] notes to stock is the same as its basis was in the

¹ See copies of unsigned subordinated notes dated [REDACTED] and [REDACTED].

² See letter to [REDACTED], Chairman of the Board of [REDACTED] dated [REDACTED].

notes (\$).

Presumably 's position is that the conversion is a recapitalization under § 368(a)(1)(E) and they are entitled to a carryover basis under §§ 358 and 354.

claimed a loss under § 331 equal to the difference in its asserted basis and the fair market value of the assets it received in the liquidation.

We have requested copies of the share certificates that were purportedly issued by but has failed to provide them. As of this date, we are unaware of any stock outstanding other than the common shares owned by .

Law and Analysis:

The incidence of taxation depends on the substance of a transaction. To allow the true nature of a transaction to be disguised by mere formalisms, existing solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress. Commissioner v. Court Holding Company, 324 U.S. 331, 334 (1945).

In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding.

Helvering v. Lazurus & Co., 308 U.S. 252, 255 (1939).

As a result of 's recapitalization of including the forgiveness of 's investment in as reported on 's books was reduced from (\$) to (\$) plus the note equal to (\$) or a total of \$.

After the recapitalization, the total equity in was the \$ contributed by and the \$ of or, \$. On a relative basis, 's share of the equity was percent (\$ /\$) and 's was percent (\$ /\$).

This represents an increase of percent to and a decrease of percent to .

In substance our view as to what actually occurred is that [REDACTED] transferred a portion of its ownership in [REDACTED] to [REDACTED]. See, e.g., Rev. Rul. 73-233, 1973-1 C.B. 179 in which the IRS took the position that a shareholder's surrender of stock to a corporation can be recast as a transfer of stock to the other shareholders.

This finding is as a result of the relative increase and decrease in values of the respective equity interests as a result of the debt forgiveness. Thus, the relative value of [REDACTED]'s ownership interest of [REDACTED] decreased from [REDACTED] percent to [REDACTED] percent and the relative value of [REDACTED]'s ownership interest increased from [REDACTED] percent to [REDACTED] percent.

Since [REDACTED] was in control of [REDACTED] within the meaning of § 368(c) (both before and) after the exchange, the transfer is considered to be a §351 exchange in which stock of [REDACTED] was transferred by [REDACTED] to [REDACTED] in exchange for additional stock of [REDACTED].³ Additional stock was not required to be issued in the exchange to qualify under §351. Sol Lessinger v. Commissioner, 872 F. 2d 519, [63 AFTR 2d 89-1055] (2d Cir. 1989) rev'g on another issue 85 T.C. 824 (1985).

Section 362 determines [REDACTED]'s basis in the [REDACTED] stock received by [REDACTED] from [REDACTED]. Under §362, [REDACTED]'s basis in the [REDACTED] stock received is the same as the basis was in that stock in the hands of the transferor. Under § 358, [REDACTED]'s basis in its existing stock in [REDACTED] is increased by the amount of [REDACTED]'s basis in the [REDACTED] stock that it transferred.

The basis in the [REDACTED] stock transferred by [REDACTED] to [REDACTED] is equal to the amount of the debt forgiveness, or \$[REDACTED]. Accordingly, [REDACTED]'s basis in its [REDACTED] stock is increased by \$[REDACTED].

³ Section 304 is inapplicable because the deemed issuance of additional stock in [REDACTED] is not considered property for purposes of § 317. Neither are §§ 367(a) and 367(b) applicable. Section 367 (a) would not recognize [REDACTED] as a corporation solely for purposes of determining the extent to which gain would be recognized on the § 351 transfer. There is no possible gain on this transfer and therefore [REDACTED] is considered to be a corporation. Section 367(b), although technically applicable, has no relevance to the facts of this case because there can be no deemed dividend inclusion of the § 1248 amount. Treas. Reg. § 1.367(b)-4(b).

██████████ and its basis in its ██████████ stock is decreased by
\$ ██████████ for purposes of measuring gain or loss on the
§ 331 liquidation resulting from the check-the-box election.

Please do not hesitate to contact the undersigned if we
can be of further assistance in this matter.

VICKI J. HYCHE
Associate Area Counsel
(LMSB)

By: 

KIM A. PALMERINO
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